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Monday, December 7, 2009

Contracts, Fraud & the Arbitration Clause

Unfortunately, it is not uncommon to find idiosyncratic laws within the American legal system. For example, the claim for fraudulent inducement in a contract dispute and the effect of that assertion depending on whether or not there is an arbitration clause.

An arbitration clause in a contract requires the parties to resolve any disputes through an arbitrator instead of a judge. The arbitration process is often seen as favorable because it is "speedy and not subject to delay and obstruction in the courts." *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 (1967). The federal government expressed its support of arbitration clauses by passing the Federal Arbitration Act ("FAA"), which makes the arbitration process binding and parties relinquish their right to challenge a final decision by instituting a court action. Therefore, in a contract dispute, if the contract has an arbitration clause, the dispute must be heard before an arbitrator, unless the arbitration clause is specifically challenged.

A claim for fraud in the inducement basically states that the contract cannot be enforced as written because it was agreed to based on fraudulent claims by the party trying to enforce the contract. Fraud is a basis for voiding a contract either in its entirety or specific terms because there was no "meeting of the minds." Such mutual consent is a necessary element to the formation of a valid contract.

While a finding of fraud in the inducement will usually void an entire contract, if there is an arbitration clause, the federal court may proceed to adjudicate it only if the claim of fraud is in the inducement of the arbitration clause itself. *Id.* The *Prima Paint* Supreme Court found that the statutory language of the FAA did not permit the federal court to consider claims of fraud in the inducement of the contract generally. *Id.* Therefore, claims of fraud in the inducement of the entire

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agreement must be submitted to the arbitrator for resolution unless expressly excluded by the arbitration provision. However, if a party claims fraud in the inducement of the arbitration clause itself, this would avoid the enforceability of the arbitration clause.

In Justice Black's dissenting opinion in *Prima Paint*, where the plaintiff contended that it would not have executed any contract, including the arbitration clause, if it were not for the fraudulent representations of the defendant, Justice Black recognized the faulty logic of the FAA interpretation. *Id.* at 415 (Black, J., dissenting). Justice Black noted that the two special values of arbitration – (1) expertise of an arbitrator and (2) the speed of the arbitration process – would not be served where a contract is sought to be rescinded on the ground of fraud. *Id.*

“On the one hand, courts have far more expertise in resolving legal issues which go to the validity of the contract than do arbitrators. On the other hand, where a party seeks to rescind a contract and his allegation of fraud in the inducement is true, an arbitrator's speedy remedy of this wrong should never result in resumption of performance under the contract. And if the contract were not procured by fraud, the court, under the summary trial procedures provided by the Act, may determine with little delay that arbitration must proceed.” *Id.* at 416 (Black, J., dissenting).

The legal distinction of claiming fraud in the inducement of the contract generally versus fraud in the inducement of the arbitration clause specifically is idiosyncratic. When one is fraudulently induced into an agreement, which includes an arbitration clause, then the case should be heard at trial because fraudulent inducement of the entire agreement includes fraudulent inducement of the arbitration clause as well. A party forced into arbitration is bound by the arbitrator's final decision, has no right to a jury, and cannot appeal the decision in a subsequent court hearing. There should not be a requirement that a separate and express claim be made of fraud in the arbitration clause itself for that matter to be heard before a judge.

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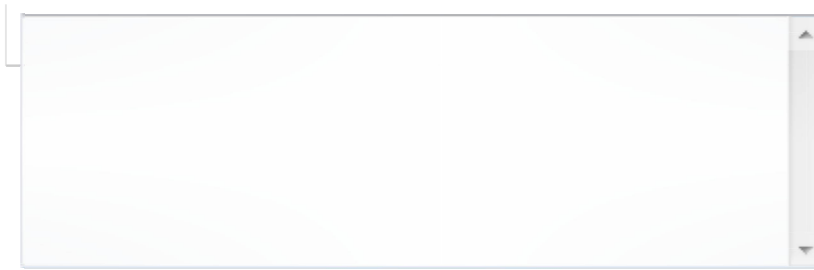
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